metadata, citation and similar papers at core.ac.uk
brought to you by
provided by Research Papers in Ec

Time to Rethink "Too Big To Fail"

The cover story of this issue of *Region Focus* discusses the U.S. corporate bankruptcy system. The article points out some of the strengths and weaknesses of that system, from the standpoint of economic efficiency. The system is not perfect. For instance, firms that are no longer economically viable may be able to find sympathetic judges who postpone liquidation beyond a period that would be optimal for the economy as a whole. It would be better, in some of those cases, to expedite the liquidation, freeing up valuable resources that could be more effectively used elsewhere.

But, in the main, the corporate bankruptcy system, which has evolved over many decades, works relatively well. It provides an opportunity for fundamentally sound companies that are experiencing temporary difficulties to reorganize and get back on their feet. And it includes measures that guide the orderly closing of firms which cannot effectively compete in their respective markets.

An example of such a firm, which the article discusses in some detail, is the electronics retailer Circuit City, based here in Richmond. It operated in an extremely competitive environment in which consumers are highly discriminating. Ultimately, enough of those consumers opted to shop with Circuit City's competitors that the firm could not survive. For many of the former employees of Circuit City, this is no doubt painful. The change that results from competition is not always pleasant, but it is essential to the functioning of a healthy market economy.

For most sectors of the economy, policymakers recognize that there should and will be frequent change, including the failure of some firms. And the corporate bankruptcy system helps to facilitate those closures in a way that is generally beneficial to the economy.

There are, however, a few exceptions: sectors that many policymakers believe include firms which simply cannot be allowed to fail. The most obvious example is the financial sector. Financial institutions are, of course, crucial to a market system. They provide the liquidity needed by businesses across the economy. But because of their unique function in the economy, should they be protected from failure?

That is a difficult question. It is possible that the failure of a particularly large firm could cause great harm to the economy. But first we should ask why so many big financial institutions came under enormous stress over the past year. There are several reasons, to be sure, but a significant factor was that many of them believed they were "too big to fail" — that is, they were willing to take excessive risks because they were confident they enjoyed either explicit or implicit public support. And, of course, such support has been forthcoming in numerous cases.

As a result, some people have called for the creation of a systemic risk regulator to oversee all financial institutions. Ultimately, such a regulator could prove useful, though I am generally skeptical of the idea. One thing seems clear, however. Redesigning our financial regulatory system before establishing clear boundaries around the federal financial safety net — boundaries that I believe should be much tighter than at present — would be like putting the cart before the horse.

The financial crisis should lead us to think hard about the incentives that financial institutions face — and what we can do to reform them to bring greater stability to the system, while at the same time not discouraging innovation. At the top of the list is rethinking whether "too big to fail" protections move us toward that goal or away from it.

JEFFREY M. LACKER
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND